REV-19 DECREASE MAXIMUM LIMITS ON PENSION CONTRIBUTIONS AND PENSION BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Decrease Limits to $60,000 and $15,000	0.6	1.7	1.9	2.2	2.4	8.7

Employers can make contributions to qualified pension and profit-sharing plans on a tax-favored basis. Currently, employers cannot contribute annually more than 25 percent of compensation or $30,000 per employee to defined contribution plans, and they cannot fund defined benefit plans that will result in annual benefits above 100 percent of wages or $90,000 per employee. (Defined benefit plans specify the pension to be received, usually as a percentage of salary, while defined contribution plans specify the annual contribution, usually as a percentage of salary.) The limits are scheduled to be indexed for inflation starting in 1988.

H.R. 3838 would decrease the defined benefit limit for 1986 to $77,000, with indexing of that limit to resume in 1988 (reflecting inflation after 1986). It would also decrease the defined contribution limit to $25,000, with indexing of that limit to begin again when it equals 25 percent of the defined benefit limit ($19,250 in today's terms). If effective January 1, 1987, this proposal would raise $2.2 billion between 1987 and 1991. If, instead, the defined benefit limit was lowered to $60,000 and the defined contribution limit to $15,000 in 1986, with indexing of both limits to resume in 1988 (reflecting inflation after 1986), the revenue pickup would be about $9 billion between 1987 and 1991.

Private pensions of $60,000 per year and pension contributions of $15,000 per year are more than adequate to meet average retirement needs. Furthermore, Social Security benefits are almost always received along with private pensions. Maximum Social Security benefits for a couple in 1984 were over $12,000. Individual Retirement Accounts (IRAs) are also available for supplementing employer pensions. Those persons most likely to be affected by a reduction in pension limits are the most likely to use IRAs. Three out of five taxpayers with incomes over $50,000 contribute to IRAs, compared with one out of five of all taxpayers. Thus, the present limits allow very-high-income people to defer and shelter income beyond amounts many would regard as necessary to provide a reasonable amount of retirement security. Lowering the limits, however, may reduce private saving.

REV-20 REPEAL THREE-YEAR BASIS RECOVERY RULE FOR CONTRIBUTORY RETIREMENT PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.8	2.2	2.8	2.9	2.9	11.6

Payments received from tax-qualified pension plans can have up to three possible components: employee's contributions, employer's contributions, and investment income accrued under the plan. When a retiree receives a payment, the component drawn from his or her own contributions (called the basis) is generally not subject to tax because those contributions usually were made from after-tax income. The general rule for deciding how much of each pension payment should be included in adjusted gross income is that the tax-exempt share should equal the ratio of the employee's basis to the expected total value of his annuity (payments over his expected life) at the time payments begin. This general rule is not followed when three years' worth of payments equal or exceed the employee's basis. In that case, no tax is due on payments until they exceed the employee's basis, after which they are fully taxable.

The three-year rule makes it more likely that annuitants will recover their contributions (or basis) before death. The current recovery rules, however, have been criticized as inequitable. First, the three-year rule is arbitrary, especially with respect to participants whose benefits exceed the basis just beyond the cutoff date. Second, regardless of which rule is applied, if distributions stop before annuitants have recovered their entire basis tax free, there is no carryover deduction to their estate. Both the President's tax reform proposal and H.R. 3838 would repeal the three-year rule, use standardized recovery periods, and allow a carryover deduction for any unrecovered basis. Repealing the three-year rule for pensions that begin payments after January 1, 1987, would raise almost $12 billion between 1987 and 1991.

The proposed shift to standard recovery periods would eliminate the acceleration of recovery that the current three-year rule causes, thus increasing revenues in the immediate term. This gain in revenues would be partially offset in later years, however, because annuitants would also exclude some benefits in later payment years (under the general rule) that would be included under current law.

A shift in current rules might harm contributory plan participants who are close to retirement, especially those who have taken the three-year rule into account in their planning. To avoid abrupt disruptions in expectations, a more gradual transition may be desirable. One possibility might be to permit a more limited form of accelerated recovery for the next several years; for example, one year of full tax-free recovery and use of the general rule for whatever unrecovered amounts might remain. A gradual transition would not raise as much revenue as a straight repeal of the three-year rule, but might be an appropriate adjustment.

REV-21 TAX A PORTION OF NONRETIREMENT FRINGE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Tax Some Health Insurance Premiums	(See ENT-01)					
Tax Life Insurance Premiums						
Income tax	1.5	2.3	2.4	2.5	2.6	11.3
Payroll tax	0.5	0.6	0.7	0.7	0.8	3.3
Disallow "Cafeteria" Plans						
Income tax	0.6	1.6	2.3	3.0	3.7	11.2
Payroll Tax	0.2	0.7	1.0	1.4	1.7	5.0

Some employer-paid, nonretirement fringe benefits are excluded from the income and Social Security tax bases even though they constitute current compensation to employees. This exclusion results in substantial revenue losses. For employer-paid health and life insurance premiums alone, the revenue loss will be about $29 billion in income tax revenues and $10 billion in payroll tax revenues in 1987. Moreover, the revenue loss from this exclusion is growing as employees seek to increase the percentage of total compensation that is received tax free. This continuing erosion of the tax base will mean that tax rates on remaining income must be increased to raise the same revenues.

Tax-free benefits also include employer-paid dependent care, which represents revenue losses of under $100 million per year through 1991, and miscellaneous benefits such as employee discounts, meals provided on premises for the convenience of the employer, benefits provided at no additional cost to the employer, *de minimus* fringe benefits, and on-premises athletic facilities. The exclusion of some fringe benefits expired on December 31, 1985. These benefits are legal service plans, transportation (van pools), and educational assistance.

Strong equity arguments exist for taxing fringe benefits. At present, a taxpayer receiving no fringe benefits pays more tax than another with the same total income but a larger share in fringe benefits. The benefits of the exclusion are greater for those with higher incomes for two reasons: these taxpayers tend to receive more fringe benefits and they face higher marginal tax rates, making the exclusion worth more to them.

Arguments against the exclusion can also be made on the basis of efficiency. Employees may bargain for tax-free benefits that they would not be willing to pay for out of after-tax income, thereby leading to over-consumption of the tax-free services. For example, employer-paid health insurance plans may have contributed to the strong growth in demand for health care, which may have contributed to recent sharp rises in health care costs.

An equity argument can be made for retaining a partial exclusion. A taxpayer with an all-cash income may have a greater ability to pay taxes than one with the same total income receiving a large percentage of income as employer-paid benefits, since the employer-paid benefits may not be worth as much to him or her as an equal dollar amount of cash wages. On the other hand, if the exclusion was eliminated, employees might insist on receiving cash instead of benefits.

The measurement of some fringe benefits for purposes of taxation presents administrative problems. Assessing the value of some benefits can be very difficult; for example, some airlines provide employees with reduced-fare or free trips where the cost to the carrier of servicing one extra passenger is essentially zero. Further, the costs of collecting taxes on small fringe benefits (such as employee discounts) could exceed the revenue collected. The inclusion of employer-paid health insurance and life insurance premiums in the tax base, on the other hand, would create only minor administrative problems. The premiums paid to each employee could be reported on the employee's W-2 form, and withholding computed as it is for other taxable income (this is already done for some life insurance premiums, as noted below). In contrast, the measurement of insurance values is more difficult when benefits are provided directly, as when employers provide medical care or reimburse employees for medical costs incurred (under self-insurance plans).

Tax Some Employer-Paid Health Insurance Premiums. The present exclusion for employer-paid health insurance premiums has been criticized as particularly inequitable. The exclusion is not currently available to the self-employed. Further, qualified health insurance plans (except self-insured medical reimbursement plans) may tilt benefits primarily to top management (other fringe benefits are governed by nondiscrimination rules to curb such practices). In addition, overuse of medical insurance may have led to expanded use of health care services and, thus, driven up prices for all taxpayers--not just for recipients of tax-free health insurance coverage.

The President's tax reform proposal would include in taxable income the first $10 per month (for single coverage) or $60 per month (for family coverage); H.R. 3838 would retain the current law exclusion for health insurance benefits. Two proposals to tax some employer-paid health insurance premiums are described in ENT-01.

Tax Employer-Paid Life Insurance Premiums. Employer-paid group term life insurance premiums are currently excluded from taxable income, but the exclusion is limited to the cost of the first $50,000 of insurance, and nondiscrimination rules apply. The exclusion is not available to the self-employed. Repeal of this exclusion would add $1.5 billion to income tax revenues and $0.5 billion to payroll tax revenues in 1987. Over the period 1987-1991, repeal would yield about $11 billion and $3 billion, respectively.

A problem may exist with taxing employer-paid life insurance because many employers provide death benefits under pension plans as a substitute for life insurance. Employer contributions to pension plans are income tax-deferred (and the first $5,000 of death benefits paid are tax-exempt) and are exempt from the payroll tax. If only employer-paid life insurance plans were made taxable, employers might choose to offer less life insurance and larger pension plan death benefits instead.

An alternative to repeal would be to reduce the limit on the exclusion. By reducing the limit from the cost of $50,000 of insurance to the cost of $30,000, about $10.5 billion in revenue would be raised in the 1987-1991 period.

Both the President's tax reform proposal and H.R. 3838 would retain the current law exclusion for life insurance benefits.

Disallow "Cafeteria" Plans. One vehicle for providing a range of employer-paid fringe benefits is a so-called cafeteria plan, under which employees may choose between taxable and nontaxable fringe benefits. The Deficit Reduction Act of 1984 restricted the benefits allowable under such plans. At present, a cafeteria plan may allow a choice of cash, employer-paid group term life insurance, disability insurance, accident and health insurance, dependent care benefits, and contributions to cash or deferred compensation arrangements (usually called 401(k) plans).

Cafeteria plans cause a revenue loss only because the plans provide benefits that are tax-exempt or tax-deferred. To the extent that the separate tax preferences for these benefits were repealed, allowed to expire, or limited as described above, both the benefits of cafeteria plans and the associated revenue losses would be reduced.

As long as the preferences remain in force, however, cafeteria plans pose equity problems similar to the tax preferences for fringe benefits when provided separately. Cafeteria plans may be a more efficient way of providing these benefits, however, because taxpayers are not required to accept benefits they do not need--they may choose cash instead. On the other hand, by expanding the availability of the tax preferences and allowing some taxpayers to convert taxable cash compensation into tax-preferred forms of income, cafeteria plans exacerbate the efficiency problems posed by those preferences.

The annual revenue loss from cafeteria plans is projected to grow at a rapid rate, from an estimated $1.4 billion in 1987 to $5.4 billion by 1991. Repeal of cafeteria plan provisions, while maintaining the current tax status of separate fringe benefits, would raise about $16 billion between 1987 and 1991.

REV-22 TAX CASH ALLOWANCES AND THE RENTAL VALUE OF HOUSING PROVIDED TO PERSONS IN THE UNIFORMED SERVICES AND THE CLERGY

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Tax All Allowances	1.7	2.5	2.6	2.8	2.9	12.5
Limit Homeowners' Interest Deductions	0.1	0.3	0.4	0.3	0.4	1.5

In general, the tax code treats all compensation in cash or in kind as taxable unless it is explicitly excluded. Thus, for example, an employer allowance for housing is taxable, as is the value of housing provided on the employer's premises (unless the housing is provided for the benefit of the employer and acceptance of the housing is a requirement of the job). People in the uniformed services and the clergy who live in private housing, however, receive tax-free allowances for housing. Some others in the services and the clergy choose to live on site even though they are not required to, and they are not taxed on the rental value of the housing services they receive. Finally, people in the military also receive small amounts of other tax-free allowances, primarily the subsistence allowance. Taxation of all cash allowances and the rental value of some housing provided for the uniformed services and the clergy would raise about $12 billion between 1987 and 1991.

Advantages of the proposal are clearer budgeting of costs and greater tax equity. Federal budgeting would be clarified by making the full cost of employees in the uniformed services more apparent in the budgets of the uniformed services. At present, a portion is hidden in tax subsidies. Tax equity would be enhanced by taxing recipients of allowances according to their ability to pay. When allowances are tax free, all recipients pay the same zero rate. When they are taxable, those with greater ability to pay--because of extra earnings from a spouse, fewer dependents, or greater amounts of nonwage income--pay a higher rate.

Disadvantages of the proposal are the possible changes in the military work force and difficulties in valuing on-site housing. Raising the tax burden on people in the uniformed services may encourage some of them to leave and discourage others from signing up. Increasing pay to maintain the services at their present size and quality could more than offset the federal savings from taxation, thereby raising the federal deficit. This increase might occur because the tax preference, unlike higher pay, triggers a subsidy by many states in the form of corresponding exemptions from state income taxes. The complexity of measuring the value of housing provided by the employer could be avoided by including only cash housing allowances in the tax base. Such a limit, however, would encourage the uniformed services and churches to build more on-site housing even where off-site housing was feasible and less costly.

An alternative to taxing all special allowances would be to limit the generally available mortgage interest and property tax deductions to amounts in excess of any tax-free housing allowance. Currently, a homeowner receiving a tax-free housing allowance can deduct all interest and property tax payments on the home even though the allowance provided to pay for the home is untaxed. In the proposal, for example, a person with a $6,000 tax-free housing allowance and $7,000 in interest and taxes on a home would be allowed to deduct only $1,000. If the person had $5,000 in interest and taxes on a home, nothing would be deductible. The proposal would raise $1.5 between 1987 and 1991.

This alternative would effectively eliminate the tax-exemption of housing allowances for those with mortgage interest and property tax deductions equal to or greater than the tax-free allowance. As a result, the limit would improve equity between these persons and mortgagees outside the military and clergy who must pay tax on all of their cash compensation. On the other hand, service personnel and clergy with mortgage interest and property tax deductions less than their allowance would still retain a partial tax exemption, and those with no homeowner deductions would retain the full tax exemption. Thus, the limit would substantially reduce the generally available tax incentive for homeownership for those in the services and clergy who must obtain a mortgage to buy a home. Because renters would be unaffected, however, it would not necessitate as large an increase in military pay to attract the same personnel as would full taxation of housing allowances, and would probably result in net budgetary savings.

Revenue Ruling 83-3 will limit the clergy's mortgage interest and property tax deductions to the excess above any tax-free allowance, effective January 1, 1987. The limit could be extended to the military. H.R. 3838, however, would override this ruling by providing an explicit full deduction of mortgage interest payments for the clergy and uniformed services.

REV-23 RESTRICT DEDUCTIONS FOR BUSINESS ENTERTAINMENT AND MEALS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Disallow Deductions for Business Entertainment and Limit Deductions for Business Meals	0.5	1.1	1.4	1.7	2.1	6.7
Limit Deductions to 50 Percent for Business Entertainment and 75 Percent for Business Meals	1.7	3.2	3.8	4.4	4.9	18.1
Limit Deductions to 80 Percent for Business Entertainment and Meals	1.4	2.6	3.1	3.5	3.8	14.4

In general, the tax code allows deductions for expenses necessary to earn income, including expenses for business entertainment and meals. The code does not usually allow deductions for costs of personal consumption. Unlike many other business-related expenses, it is very difficult to distinguish between meal and entertainment expenses required for business purposes (which should be deductible) and those that give rise to personal consumption (which should not reduce tax liabilities). For example, theater and football tickets, country club dues, and parties or meals at expensive restaurants may all be deductible as business expenses under current law. Restricting these deductions as described below would add about $18 billion to revenues in 1987 through 1991.

Elimination of the deduction for business entertainment has been proposed on grounds of both equity and efficiency. Some people argue that it is not equitable to permit a few taxpayers to deduct expenses for items such as football tickets, while most people must pay for them with after-tax dollars. Another argument is that the deduction encourages more spending on entertainment than would occur if these activities were not subsidized by the tax system, and that this may have increased the prices of some forms of entertainment for all attendees. Limiting the deduction for business meal expenses has been proposed on the grounds that many of these expenses are greater than necessary to conduct business.

The President's tax reform proposal would disallow most deductions for business entertainment expenses (excepting expenses for items taxed as compensation to beneficiaries, recreational expenses for employees, and items made available to the general public). It would limit deductions for a business meal to $25 times the number of participants plus half of the remaining expenditures for the meal. If made effective January 1, 1987, this proposal would raise about $7 billion in revenues from 1987 through 1991.

Limiting the deduction for business meals as in the President's proposal would probably reduce the number of meals served at expensive restaurants, but would not significantly affect most restaurants. One difficulty with the $25 base of the limit is that it does not have the same value to all taxpayers across the country. Restaurant prices, for example, are generally higher in large urban areas than in smaller cities.

The House Committee on Ways and Means staff proposal of 1985 would have allowed a deduction for 50 percent of business entertainment expenses and 75 percent of business meal expenses. If made effective January 1, 1987, this proposal would raise about $18 billion from 1987 through 1991. The House enacted instead, in H.R. 3838, a proposal to allow a deduction for 80 percent of all business entertainment and meal expenses. If made effective January 1, 1987, this proposal would raise about $14 billion through 1991.

Eliminating or limiting business meal and entertainment deductions could have some negative effects on the restaurant and entertainment industries because a large fraction of meals and tickets to sporting and theater events is purchased by businesses. For example, about one-third of all baseball tickets and one-half of all hockey tickets are purchased by business firms.

REV-24 ELIMINATE STATE AND LOCAL TAX DEDUCTIBILITY

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Eliminate Deductibility of State and Local Taxes						
Income taxes	3.4	23.3	25.2	27.3	29.5	108.7
Sales taxes	0.8	5.2	5.7	6.3	6.9	25.0
Property taxes	1.8	12.0	13.2	14.5	15.9	57.3
Maintain Deductibility of Taxes Above Floor of 1 Percent of AGI	0.8	5.2	5.6	6.0	6.4	24.0

Current law allows taxpayers to deduct state and local taxes, including sales, income, real estate, and personal property taxes. These deductions are estimated to reduce revenues by about $190 billion between 1987 and 1991.

These deductions indirectly increase state and local revenues because they enable states to impose somewhat higher taxes than if taxpayers faced their full burden. In addition, the deductions tend to reduce differences in effective tax rates among states, which may to some extent diminish the importance of taxes in location decisions by business and households.

For people in high tax brackets, the deduction lowers the cost of supporting public services and induces higher spending levels in upper-income communities, particularly for such services as public education. These higher spending levels are subsidized by all taxpayers and may thwart state efforts to equalize spending levels among different communities. In some economically more diverse areas, such as central cities, the deduction may induce wealthy itemizers to favor higher spending for services that also benefit lower-income nonitemizers, but the impact on spending would not be as large as in high-income communities because fewer voters itemize. Without deductibility, however, higher-income itemizers might be less willing to reside in high-tax jurisdictions with large low-income populations.

While the deductions subsidize state and local expenditures, they reduce tax liability directly only for taxpayers who itemize--largely middle- and upper-income taxpayers. The value of the deductions increases with the marginal tax rate so that they are worth more to wealthy itemizers than to those in lower brackets. (This is also true for other deductions, such as mortgage interest and charitable contributions.) Finally, deductibility discourages states and localities from using nondeductible user fees, thereby inhibiting efficient pricing of some services.

On the other hand, to the extent that state and local taxes paid by any taxpayer exceed the benefits that taxpayer receives from state and local spending, deductibility can be regarded as a legitimate adjustment in measuring net income, and therefore the ability to pay federal taxes. Deductibility may also encourage states to impose more progressive taxes than they otherwise would. Advocates of deductibility also argue that it encourages states and localities to provide a greater quantity of public goods, such as education, transportation, and pollution control, which have spillover effects that benefit people outside the taxing jurisdiction. The belief that state and local public spending should be encouraged does not imply, however, that the current state and local deduction is necessarily the best way to do so, since it does direct a large share of the subsidy to upper-income communities.

The President's tax reform proposal would eliminate deductibility of all state and local taxes unless they are incurred in carrying on a trade or business. H.R. 3838 would retain deductibility. Other recent proposals call for partial elimination of state and local tax deductibility.

Some favor repeal only of the sales tax deduction. This would add about $25 billion to federal revenues between 1987 and 1991. The tax code generally allows deductions for relatively large and unpredictable expenses that affect a taxpayer's economic circumstances. Uniform expenses affecting nearly all taxpayers have traditionally been subsumed in the zero bracket amount and in the exemptions of the tax structure. The sales tax deduction, by virtue of the way it is computed (from standardized tax tables with amounts varying only by state, family size, and income) and its scope of coverage (claimed by nearly all itemizers) fails to meet these general criteria.

Advocates of the sales tax deductions argue that the federal government should not influence the states' choice of taxes by permitting only some of them to be deducted. Eliminating this deduction would be more burdensome for states relying heavily on sales taxes, and could cause some states to shift their tax collections from sales taxes to other taxes to preserve deductibility for their residents. To the extent other tax sources were substituted for the sales tax, the revenue gain would be reduced.

An alternative that would not discriminate among tax sources would be to permit deductions of all taxes above a fixed percentage of adjusted gross income (AGI). If the floor was set at 1 percent, revenues over the 1987-1991 period would increase by $24 billion. Such a measure would preserve most of the impact of the present deductions on public spending, but still capture taxes paid by upper-income itemizers. Another alternative would be to permit only a fraction of state and local taxes to be deductible. Yet another option would be to prohibit deductions above a fixed ceiling, which might be a percentage of adjusted gross income or a fixed dollar amount. A ceiling would result in greater variation in after-tax income from state to state and would largely eliminate the federal subsidy of public spending.

REV-25 LIMIT INTEREST DEDUCTIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Limit to Mortgage Interest on a Principal Residence Plus $5,000 in Excess of Net Investment Income	0.3	2.1	2.3	2.4	2.6	9.7
Limit to $20,000 (Joint Returns)or $15,000 (Other) in Excess of Net Investment Income	0.3	2.3	2.4	2.6	2.9	10.5

Current law allows taxpayers who itemize deductions to deduct all interest payments on home mortgages, auto loans, credit card balances, and other consumption borrowing. In addition, they can deduct interest on borrowing that is invested--for example, in stocks--but this deduction is limited to $10,000 in excess of net investment income. About one-third of all taxpayers itemize interest, claiming an average of almost $4,200 in 1983. As a result, the tax expenditure for this category is over $250 billion (for the period 1987 through 1991)--among the largest of conventionally defined tax expenditures.

Under an income tax, only interest that is a cost of earning taxable income is properly deductible. This does not include borrowing for homes, cars, and other assets that do not generate taxable income. (Deductibility of mortgage interest has been justified instead as an incentive to homeownership.)

Limiting interest deductions is one way to reduce tax shelter activity. High-bracket taxpayers may find it profitable to borrow in order to finance purchases of houses, consumer durables, and investment assets that generate tax-preferred income (such as partnership shares in extractive industries or real estate). When current interest deductions for an asset exceed currently taxable income from that asset, the excess interest deductions serve to shelter other income from tax. This "tax arbitrage" is the principle on which tax shelters operate.

The President's tax reform proposal would allow an unlimited deduction for interest payments on debt secured by the taxpayer's principal residence (limited to the fair market value of the home), but would limit deductions for other interest payments to $5,000 in excess of net investment income. The President's plan proposed a 10-year phase-in. Limiting only nonmortgage interest deductions would favor homes over cars, education, and other major purchases. Furthermore, homeowners might avoid the limit by using their homes as collateral to finance other purchases. Taking account of this behavior, this proposal is estimated to raise about $10 billion from 1987 through 1991, if implemented fully on January 1, 1987.

H.R. 3838 would limit itemized interest deductions to mortgage interest on a taxpayer's primary and secondary residences plus $20,000 (for joint returns, $10,000 for others) in excess of net investment income. If also implemented January 1, 1987, this provision would add less than $0.5 billion to revenues for the 1987-1991 period.

An alternative proposal to limit itemized interest deductions to $20,000 over investment income for joint returns and $15,000 for others would also leave a substantial incentive for home or other consumer borrowing. It would raise about $10.5 billion over the 1987-1991 period. At a 13 percent interest rate, taxpayers filing joint returns could deduct all interest on at least $150,000 of borrowing; single filers could deduct all interest on at least $115,000 of borrowing. Taxpayers with homes currently priced over $200,000, however, would probably suffer declines in the value of their homes.

Decreasing the incentive for further consumer borrowing would free savings for business investment, thereby offsetting in part a tax bias that favors investment in consumer durables. Those who favor retaining the deduction for nonbusiness interest note that otherwise many taxpayers could increase business-related borrowing to obtain cash for nonbusiness purchases. Consequently, eliminating deductions for nonbusiness borrowing would only affect taxpayers without sufficient financial wealth against which to collaterize loans for nonbusiness purposes. In short, it would raise the costs of financing housing, automobiles, and other consumer durables only for taxpayers without other sources of wealth.

REV-26 COMBINE MISCELLANEOUS DEDUCTIONS AND EMPLOYEE BUSINESS EXPENSE DEDUCTIONS AND SUBJECT TO A FLOOR OF 1 PERCENT OF AGI

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Treat Combined Deduction as an Adjustment to Income	0.3	2.1	2.3	2.5	2.7	9.9
Treat Combined Deduction as an Itemized Deduction	0.5	3.7	4.0	4.3	4.6	17.1

Current law generally allows taxpayers to deduct costs of producing income. In addition, certain employee business expenses are deductible when computing adjusted gross income (AGI) whether or not taxpayers itemize deductions, including expenses for travel, meals, and lodging while away from home, transportation expenses (except expenses of commuting to and from home), and business expenses of employees who are in sales. In 1983, about 8 percent of returns claimed a deduction for employee business expenses, with an average deduction of about $2,400 per return.

Other employee expenses are deductible only by taxpayers who itemize deductions. These are categorized as miscellaneous itemized deductions, and include employee business expenses for education, union and professional dues, safety equipment, small tools, supplies, uniforms, protective clothing, subscriptions to professional publications, and employment agency fees. Also allowed are gambling losses (limited to gambling winnings) and other expenses of producing income such as fees for investment services, rental fees for safe deposit boxes, trustee fees, and tax return preparation fees. About a third of all tax returns claim miscellaneous itemized deductions, with an average of about $630 per return.

Both the President's proposal and H.R. 3838 would combine miscellaneous itemized deductions with employee business expense deductions and limit the combined deduction to amounts in excess of 1 percent of AGI (computed without regard to the deduction). Under the President's proposal, the combined deduction would be allowed when computing adjusted gross income for both itemizers and nonitemizers. Under H.R. 3838, the combined deduction would be treated as an itemized deduction--that is, it would be available only to itemizers. The President's proposal would remove an inequity in the current law treatment of costs of producing income by making the deduction available on the same terms to nonitemizers and itemizers. The percent-of-AGI floor on the deduction in both proposals would simplify recordkeeping problems for taxpayers who now deduct only small amounts, and would reduce enforcement problems for the Internal Revenue Service. Both proposals, however, deny otherwise legitimate deductions to some taxpayers simply because the deductions are a small share of AGI. Of those who now claim miscellaneous itemized deductions, about half claim amounts smaller than 1 percent of AGI.

The 1 percent floor under miscellaneous deductions and employee business expenses, as proposed by the President, but implemented January 1, 1987, would increase federal revenues by about $10 billion between 1987 and 1991. If the deduction was available only to itemizers, as in H.R. 3838, but implemented January 1, 1987, the proposal would raise about $17 billion between 1987 and 1991.

REV-27 INCREASE TAXATION OF NON-MEANS-TESTED ENTITLEMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1989	1991	
Increase Taxation of Social Security and Railroad Retirement Tier I						
Tax 50 percent of benefits	2.2	7.5	7.9	8.3	8.8	34.7
Tax 85 percent of benefits	5.3	17.9	19.1	20.3	21.5	84.1
Tax All Unemployment Compensation	0.3	0.8	0.8	0.8	0.8	3.5
Tax Workers' Compensation and Black Lung Benefits	0.8	2.8	3.1	3.4	3.8	14.0

Under current tax law, certain entitlement benefits are included in adjusted gross income (AGI), while others are completely or partially excluded. Until recently, most entitlements were exempted from income taxation. But, because the transfer payments made to beneficiaries were small, the revenue loss from the tax exemptions was negligible. In recent years, however, such transfers have reached more well-to-do households and gradually accounted for large amounts of family income. If transfers were to be taxed the same way as other sources of personal income, it would be necessary to include in adjusted gross income all Social Security benefits and Railroad Retirement Tier I benefits in excess of employee contributions, all unemployment insurance benefits, and the income maintenance portion of workers' compensation benefits.

Other entitlement benefits currently not subject to tax include: the value of Medicare Hospital Insurance (HI) coverage in excess of an individual's HI payroll contribution; the subsidy for Supplemental Medical Insurance premiums (SMI) under Medicare; and all means-tested entitlement